SUPREME COURT, U.S.

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IN THE

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1965.

No. 372

JOHN E. and ESTHER D. McCULLOUGH,
Petitioners,

v.

THE UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI
To the United States Court of Claims.

ROBERT T. MOLLOY,
Attorney of Record for Petitioner,
1527 New Hampshire Avenue, N. W.,
Washington, D. C. 20036.

Of Counsel:
GEORGE E. BAILEY,
906 Olive Street,
St. Louis, Missouri 63101.

ST. LOUIS LAW PRINTING CO., INC., 415 N. Eighth Street. CEntral 1-4477.

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THE UNITED STATES OF AMERICA,
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PETITION FOR A WRIT OF CERTIORARI
To the United States Court of Claims.

John E. and Esther D. McCullough pray that a writ of certiorari issue to review the judgment of the United States Court of Claims in this case.

CITATION TO OPINION BELOW.

The opinion of the Court of Claims (Appendix A, *infra*, p. 11) is reported at 344 F. 2d 383.

JURISDICTION.

The Opinion, Findings of Fact and Conclusion of Law of the Court of Claims dismissing the petition was issued

on April 16, 1965 (Appendix A, infra, pp. 11-50). A timely motion to correct the opinion was granted on April 26, 1965 amending the decision of April 16, 1965 and ordering the amount of recovery in accordance with finding 22(ii) to be determined pursuant to Rule 47(c)(2), (Appendix A, infra, pp. 47-54). The judgment of the Court of Claims was entered on June 18, 1965 (Appendix A, infra, p. 48). The jurisdiction of this Court is invoked under 28 U. S. C., 1255(1).

QUESTION PRESENTED.

Does the earnings and profits account of a corporation survive a recapitalization culminating a reorganization under Section 77 of the Bankruptcy Act for the purpose of determining the nature of corporate distributions thereafter made to shareholders where the recapitalization qualifies as a reorganization under the income tax laws?

STATUTES INVOLVED.

The statutory provisions are sections 301 and 316 of the Internal Revenue Code of 1954 and the pertinent portions thereof are set out in Appendix B, *infra*, p. 52.

STATEMENT.

This case involves the federal income tax liabilities of the petitioners, husband and wife, for the calendar years 1957 and 1958. The amounts claimed as having been overpaid are respectively, $42.75 and $217.77 for a total of $260.52. It is agreed that petitioners incurred a long-term capital loss in 1957 and are entitled to a deduction in 1958 as a result thereof, the amount, however, being dependent upon the resolution of the principal issue presented (Finding 11, App. A, *infra*, p. 42).[1]

[1] The findings of fact by the Trial Commissioner were adopted by the Court of Claims and are set out at pages 28 through 39 of Appendix A, *infra*. Hereinafter references to such findings will cite only the appropriate page of Appendix A.

The question raised is whether the entire distributions made to the petitioners during 1957 and 1958 by the St. Louis-San Francisco Railway Company[2] with respect to shares of its stock were dividends by statutory definition. The answer in turn depends upon the extent to which the distributions are to be considered as having been made out of accumulated earnings and profits. Petitioners claim that the deficit in earnings and profits accumulated prior to a recapitalization of the Frisco culminating a reorganization under Section 77 of the Bankruptcy Act must be taken into account in the determination of what portion, if any, of the distributions constituted statutory dividends taxable to them as ordinary income. The facts are not in dispute.

The Frisco is a common carrier by rail operating in interstate commerce and is subject to the jurisdiction of the Interstate Commerce Commission. At all times the Frisco has filed its Federal income tax returns on a calendar-year basis in conformity with the accrual basis of accounting (App. 29).

On November 1, 1932, the United States District Court for the Eastern District of Missouri appointed a receiver for the Frisco. Its properties were thereafter operated by receivers until October 1, 1933 (App. 31). On May 16, 1933, the Frisco filed in the District Court a petition for the institution of bankruptcy reorganization proceedings (App. 31). Pursuant to a plan of reorganization confirmed by the Court on November 15, 1945, the Frisco was reorganized effective January 1, 1947 (App. 34).

As of December 31, 1932, the Frisco had post-March 1, 1913, accumulated earnings and profits, but in an undetermined amount. Its balance sheet filed with the Interstate Commerce Commission showed a surplus of $5,751,-

[2] Hereinafter referred to as the Frisco.

995.60 as of December 31, 1932 (App. 30). During the entire period of reorganization, 1933-1946, the Frisco had an aggregate net loss of $50,958,026.90 and an undetermined deficit in earnings and profits (App. 39).

In 1955 Petitioner John E. McCullough acquired 35 shares of the common stock of the Frisco as a bonus from his employer. Petitioners purchased an additional 65 shares on January 2, 1957, and 100 shares on October 18, 1957. The 35 and 65 shares were sold on December 18, 1957. In 1957 and 1958 petitioners received distributions from the Frisco on their stock in the respective amounts of $187.50 and $25.00 (App. 28). These amounts were included as dividend income in petitioners' Federal Income tax returns and Federal income tax was duly paid thereon (App. 28).

Distributions made by the Frisco to stockholders as such in each of the years 1957 and 1958 exceeded the Frisco's current earnings and profits for those years (App. 42). If the Frisco's earnings and profits are to be deemed zero as of the commencement of the receivership or reorganization proceedings and the deficit thereafter incurred survived the reorganization, then the Frisco had a deficit in its accumulated earnings and profits account at the beginning of both 1957 and 1958. If Frisco's deficit in its earnings and profits account was extinguished in the reorganization, then the Frisco had sufficient accumulated earnings and profits to cover its distributions in 1957 and 1958. If the Frisco's deficit in its earnings and profits account survived the reorganization, however, then portions of the distributions in 1957 and 1958 are not taxable as dividend income to the petitioners (App. 42, 43).

Appropriate claims for refund were filed by petitioners (App. 48). Timely suit was instituted in the United States Court of Claims to recover the overpayments claimed (App. 48). The jurisdiction of the Court of

Claims was based upon section 1491, Title 28, U. S. C. On April 16, 1965, the Court of Claims entered its opinion and order dismissing the petition (App. 11). The Court of Claims ruled that absent a determination the preexisting deficit in earnings and profits survived the completion of the reorganization, the Frisco had as of 1957 and 1958 sufficient accumulated earnings and profits so that the entire distributions would constitute dividends. On the same day, April 16, 1965, petitioners, through their Counsel of Record, filed a "Motion to Correct Opinion". On April 26, 1965, the Court of Claims amended its decision (App. 49) and ordered the amount of recovery in accordance with finding 22 (ii) to be determined under Rule 47 (c) (2). On June 18, 1965, judgment was entered accordingly (App. 50).

REASONS FOR GRANTING THE WRIT.

The decision of the Court of Claims is based upon the legal conclusion that the preexisting deficit in the earnings and profits account did not survive the completion of the reorganization in bankruptcy. This is in direct conflict in principle with the decision of the First Circuit Court of Appeals in **United States v. Snider**, 224 F. 2d 165 (1st Cir. 1955), aff'g, 125 F. Supp 352 (D. Mass. 1954), and the decision of the Tenth Circuit Court of Appeals in **United States v. El Pomar Investment Co.**, 330 F. 2d 872 (10th Cir. 1964), aff'g., 210 F. Supp. 333 (D. Colo. 1962), which decisions in turn were based upon carefully weighed interpretations of decisions of this Court dealing with the basic problems involved, **Commissioner v. Munter**, 331 U. S. 210 (1947), rev'g., 157 F. 2d 132 (3rd Cir. 1946), rev'g., in turn, 5 T. C. 108 (1945), and **Commissioner v. Phipps**, 336 U. S. 410 (1949), rev'g., 167 F. 2d 117 (10th Cir. 1948), aff'g., 8 T. C. 190 (1947).

The decision of the Court of Claims further raises an important and recurring problem in the administration

of the tax laws. The petitioners represent but one of approximately 10,000 shareholders of the Frisco situated throughout the country. A second case has been decided adversely by the Tax Court in **Paul and Ella Caspers**, Docket No. 82,431, June 23, 1965, 44 T. C. ..., No. 38. A third, fourth, and fifth are pending in the District Courts in **J. A. and Maude S. Cannon v. United States** (S. D. Cal.), **John L. Cochran v. United States** (N. D. Ill.), and **John M. Barksdale et al. v. United States** (M. D. Tenn.). Additionally, there are numerous shareholders of other reorganized corporations who are annually receiving distributions with their tax status now in doubt and subject to controversy. While the amount of revenue per individual shareholder is not large, the aggregate, due to the vast number of taxpayers affected, is great. And, as the amount of tax per shareholder is small, this doubt imposes a relatively greater burden upon each one in securing a proper determination of his rights.

The conclusions reached by the lower courts have been inconsistent and confusing. This is evidenced by the discussion in the decision of the Court of Claims. The result is grave uncertainty. It is extremely urgent and vital to the Tax Administrators, the distributing corporations and the many shareholders that a definitive and final answer be forthcoming at the earliest date. Certainty will be of far more value to any of the concerned parties than either the tax gain or loss, as the case shall be. The seriousness of the existing uncertainty lies to a great extent in the requirement of section 301 (c) (2) of the Internal Revenue Code of 1954 that the portion of the distribution which is not a dividend "shall be applied against and reduce the adjusted basis of the stock."

The initial in line decision, **Commissioner v. Sansome**, 60 F. 2d 931 (2nd Cir. 1932), cert. denied *sub nom.*, **Sansome v. Burnet**, 287 U. S. 667 (1932), rev'g., 22 B. T. A.

1171 (1931), which has given rise to so much discussion, interpretation and differences was itself contra to that of the Board of Tax Appeals and showed the deep perceptiveness of Judge Learned Hand wherein he observed that the taxpayer gets his *quid pro quo* in the closing transaction, though it is a chance whether the final resultant will be favorable or not. Thereafter, the Tax Court applied the **Sansome** rule, that a tax free reorganization is a continuation of the predecessor for determining accumulated earnings and profits, in **Sidney S. Munter**, supra, but was reversed by the Appellate Court on the basis of its own earlier decision in **Campbell v. United States**, 144 F. 2d 177 (3rd Cir. 1944), which limited the **Sansome** rule to cases where there was an identity of proprietary interests. This Court reversed the Circuit Court of Appeals with directions that the cause be remanded to the Tax Court.

In **Margaret R. Phipps**, supra, the Tax Court stated that "careful examination of the **Sansome** case is required" and "after reviewing with care the above authorities, we have come to the conclusion that the **Sansome** and **Harter** (the same court and same result) cases are controlling here". This view was approved by the Court of Appeals but with Judge Huxman dissenting, "I cannot escape the conclusion that the decision of the Tax Court is wrong and should be reversed," noting that while both parties agreed the decision was controlled by the **Sansome** rule, neither the parties nor the Court were able to agree upon the interpretation of this case. This Court reversed.

Earnings and profits do not survive a 77B reorganization, **F. R. Humpage**, 17 T. C. 1925 (1952), under the **Sansome** rule, four judges dissenting, but a deficit survives a tax free reorganization, **Snider v. United States**, *supra*, District Court, under the **Sansome** rule as defined in **Phipps**, Appellate Court. Of a similar view, **Kavanagh**

v. United States, 189 F. Supp. 430 (D. Neb. 1960), but reversed upon appeal, 308 F. 2d 824 (8th Cir. 1962), where a different view of the facts and rule of law obtained. Contra, **El Pomar Investment Co. v. United States**, *supra*, District Court, on the grounds, "the facts in the **Snider** case are analogous to those in the case at bar, and the reasoning in the **Snider** case is persuasively logical and sound," aff'd., Appellate Court, limiting the **Phipps** rule to cases of tax avoidance. In accord with **Kavanagh** while critical of **Snider** and **El Pomar**, is **Dunning v. United States**, 232 F. Supp. 915 (W. D. Mo. 1964), in interpreting the **Sansome** rule. Thus, we find today the anomolous situation of a District Court commenting unfavorably upon decisions of Courts of Appeals in other circuits pursuant to a ruling of the Court of Appeals for its own circuit.

While Section 381 (c) (2) of the 1954 Code now provides for the carry-over of earnings and profits, including deficits in the account, in certain instances of corporate acquisitions in taxable years to which said Code applies, the provisions do not resolve the problem with respect to recapitalizations nor of other types of reorganizations occurring prior to the effective date thereof, generally January 1, 1954. The issue will, therefore, continue. And, as stated, will arise with respect to a very large number of taxpayers.

The Court of Claims, furthermore, has failed to follow decisions of this Court and apply the well settled principles of corporate reorganization that when the stockholders are excluded and replaced by the creditors, then there exists a continuity of interest and ownership and such interest is related back to the time said creditors invoked the processes of law to enforce their rights, **Helvering v. Alabama Asphaltic Limestone Co.**, 315 U. S. 179 (1942) and **Helvering v. Cement Investors, Inc.**, 316 U. S. 527 (1942).

CONCLUSION.

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

ROBERT T. MOLLOY,
Attorney of Record for Petitioner,
1527 New Hampshire Avenue, N. W.,
Washington, D. C. 20036.

Of Counsel:
GEORGE E. BAILEY,
906 Olive Street,
St. Louis, Missouri 63101.

July ...., 1965.

APPENDIX A.

In the

United States Court of Claims.

No. 275-62.

(Decided April 16, 1965.)

John E. McCullough and Esther D. McCullough

v.

The United States.

Robert T. Molloy for Plaintiffs. George E. Bailey, Grant W. Wiprud, and Dale W. Wickham, of Counsel.

Philip R. Miller, With Whom Was Assistant Attorney General Louis F. Oberdorfer, for Defendant. Lyle M. Turner Was on the Brief.

Before Cowen, Chief Judge, Laramore, Durfee, Davis and Collins, Judges.

Opinion.

Collins, Judge, delivered the opinion of the court:

This is an action for the refund of Federal income tax. Plaintiffs were the owners of shares of common stock in the St. Louis-San Francisco Railway Company (hereinafter referred to as "Frisco"). During the years in question, 1957 and 1958, plaintiffs received from the Frisco distributions of $187.50 and $25, respectively. The distributions were treated in plaintiffs' (joint) Federal income tax returns as dividend income. The basis for this action is plaintiffs' assertion now that, in part, the dis-

tributions did not represent dividend income, but were, in part, a return of capital.[1] The nature of the distribu-

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[1] Section 301 of the Internal Revenue Code of 1954 states, in part, as follows:

"(a) In general.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * * * * * * *

"(c) Amount taxable.—In the case of a distribution to which subsection (a) applies—

"(1) Amount constituting dividend.—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

"(2) Amount applied against basis.—That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock..

"(3) Amount in excess of basis.—

"(A) In general.—Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

"(B) Distributions out of increase in value accrued before March 1, 1913.—That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax."

Section 316 of the Internal Revenue Code of 1954 states, in part:

"(a) General rule.—For purposes of this subtitle, the term 'dividend' means any distribution of property made by a corporation to its shareholders—

'(1) out of its earnings and profits accumulated after February 28, 1913, or

"(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

"Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection."

tions depends, of course, upon the status of the Frisco's "earnings and profits account."[2]

The parties have entered into a stipulation of facts. The stipulation, which includes 10 exhibits, provided the basis for the report of the Trial Commissioner. That report, contained, *infra*, can be summarized as follows:

On November 1, 1932, the United States District Court for the Eastern District of Missouri ordered the appointment of a receiver for the Frisco. The receivership continued until October 1, 1933. On May 16, 1933, the Frisco filed in the district court a petition for the institution of bankruptcy reorganization proceedings. Ultimately, a plan of reorganization was confirmed and consummated, effective as of January 1, 1947.[3]

As of December 31, 1932, the Frisco had outstanding approximately $303,000,000 in debt securities. During the period of the receivership and the reorganization proceedings, interest of approximately $180,900,000 became due and was accrued on the securities. The Frisco, an accrual basis taxpayer, deducted the interest in its Federal income tax returns. Approximately $3,000,000 of the interest was cancelled in 1943, and, on or just prior to January 1, 1947, approximately $76,500,000 was paid in cash to the security holders. Proper treatment of the remaining interest, $101,442,452, is one of the matters in dispute. During the entire period of the reorganization, 1933-46, the Frisco had an aggregate net loss of $50,958,026.90. Deduction of the accrued interest contributed substantially to that loss.

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[2] No actual definition of "earnings and profits" is contained in the Internal Revenue Code or the regulations. But see § 312, Int. Rev. Code of 1954.

Also, see generally, 1 Mertens, Law of Federal Income Taxation, § 9.28 (rev. ed. 1962).

[3] The reorganization was pursuant to § 77 of the Bankruptcy Act, ch. 774, 49 Stat. 922 (1935), as amended, 11 U. S. C., § 205 (1958).

Under the reorganization plan, all outstanding stock, both common and preferred ($114,701,526 in face value), was eliminated and cancelled as worthless. Also cancelled were the unsecured claims which totaled $250,000. The holders of the several classes of secured indebtedness (with total principal amount of $269,119,202) received new bonds, preferred stock, common stock, and cash in full satisfaction of their claims. The total capitalization of the reorganized company was $251,628,494. (See finding 11, *infra.*) On February 28, 1947, the Commissioner of Internal Revenue issued a ruling to the effect that the Frisco plan qualified as a "reorganization" under section 112 (g) (1) of the Internal Revenue Code.[4] (See finding 18, *infra.*)

According to the stipulation of the parties, the distributions which the Frisco made to its shareholders in 1957 and in 1958 exceeded its current earnings and profits for the respective years. Also, it was stipulated that if this court determines that the preexisting deficit in earnings and profits did not survive the completion of the reorganization, then the Frisco had in 1957 and 1958 sufficient accumulated earnings and profits to cover the distributions in question. Thus, in order to recover, plaintiffs must show that the deficit in earnings and profits carried over to the reorganized corporation, whose stockholders were the previous creditors. A determination that the deficit did survive the reorganization would mean that,

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[4] Int. Rev. Code of 1939, § 112 (g) (1), as amended, ch. 247, § 213 (b), 53 Stat. 870 (1939), as amended.

It should be noted that a special set of provisions dealt with railroad reorganizations. *Cf.* Int. Rev. Code of 1939, § 112 (b) (9), added by ch. 619, § 142 (a), 56 Stat. 838 (1942), as amended, and Int. Rev. Code of 1939, § 112 (b) (10), added by ch. 63, § 121, 58 Stat. 41 (1944). Also see Int. Rev. Code of 1939, § 113 (a) (20), added by ch. 619, § 142 (b), 56 Stat. 839 (1942), and Int. Rev. Code of 1939, § 22 (b) (10), added by ch. 619, § 144, 56 Stat. 812 (1942), as amended.

to the extent of the deficit, post-reorganization accumulated earnings and profits were reduced, and, as a result, part of the distributions to plaintiffs would not be taxable dividend income.[5]

One basic argument put forth by plaintiffs is that the receivership and the reorganization had no effect upon the Frisco's deficit in earnings and profits. Thus, according to plaintiffs, the pre-January 1, 1947, deficit must be included in the computation of accumulated earnings and profits for 1957 and 1958. Plaintiffs stress the fact that the Frisco recapitalization qualified as a "reorganization" under section 112 (g) (1) of the Internal Revenue Code.[6] This court does not accept the contentions of plaintiffs.

A case identical to the one at bar, except that different Frisco shareholders were the plaintiffs, has recently been decided. **Banister v. United States**, 236 F. Supp. 972 (E. D. Mo. 1964).[7] Based upon its determination that

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[5] Sections 301, 316, Int. Rev. Code of 1954. See note 1, *supra*.

[6] Int. Rev. Code of 1939, §112 (g) (1), as amended, ch. 247, § 213 (b), 53 Stat. 870 (1939), as amended.

Plaintiffs seek to draw support from Rev. Rul. 54-482, 1954-2, Cum. Bull. 148, which provided in part that a recapitalization under § 112 (g) (1) (E) did not diminish the accumulated earnings and profits. However, this court is in agreement with defendant that the principles of Rev. Rul. 54-482 do not govern the questions presented by the Frisco reorganization. The ruling dealt with a situation in which, unlike the Frisco reorganization, the same persons were shareholders (with the same proportion of ownership) before and after the recapitalization. Also, the corporation described in the ruling had accumulated earnings and profits, as opposed to a deficit in earnings and profits.

[7] According to plaintiffs' counsel in the present case, *Banister v. United States, supra*, has been appealed to the Court of Appeals for the Eighth Circuit.

Also, according to plaintiffs' counsel, a third suit involving the precise issue is pending before the Tax Court. *Paul and Ella Caspers*, T. C. No. 82431.

there was no carryover of the deficit in earnings and profits, the court in **Banister** granted judgment for the Government. According to the district court, the Frisco emerged from the reorganization (effective January 1, 1947) with a "clean financial slate." Considerable reliance was placed upon the prior decision in **United States v. Kavanagh**, 308 F. 2d 824 (8th Cir. 1962), which also involved the taxability of a distribution received by a shareholder.

In **Kavanagh**, the distributing corporation, Bell-Sorensen, had been formed in 1940, pursuant to the reorganization under section 77B[8] of three corporations, Equity Finance and Investment Corporation and its two subsidiaries. The assets of the predecessor corporations were transferred to Bell-Sorensen. Fifty-five percent of the stock of the new corporation was distributed to the holders of Equity's bonds in full satisfaction of their claims; the remainder of the stock (45 percent) was issued in exchange for cash. The former unsecured creditors received cash to the extent of one-third of their respective claims. The former shareholders were found to have no equity. The district court held in favor of the plaintiff-shareholder on the ground that the accumulated earnings and profits of Bell-Sorensen were offset by a deficit carried over from Equity. 187 F. Supp. 430 (D. Neb. 1960). On appeal, the judgment was reversed. The decision of the court of appeals rested upon alternative grounds: first, there was not sufficient evidence to prove that Equity had had a deficit in earnings and profits; secondly, **there could have been no carryover of any deficit to Bell-Sorensen.** Regarding the effective date of the equitable ownership of the former bondholders, the court of appeals cited

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[8] Bankruptcy Act, § 77B, ch. 424, 48 Stat. 912 (1934), as amended. Section 77B was amended by the Chandler Act, ch. 577, 52 Stat. 840 (1938), and is now incorporated in chapter X of the Bankruptcy Act, 11 U. S. C., ch. 10 (1958).

Helvering v. Cement Investors, Inc., 316 U. S. 527 (1942).[9] In reaching its conclusion that Bell-Sorensen began with a "new financial slate," the court of appeals stated, 308 F. 2d at 831, the following:

> When the taxpayer in the case at bar purchased an equity interest in the reorganized company, Bell-Sorensen, the equity interest be received is to be measured by his proportionate share of that corporation's net worth at that time. He received no equity in the old debtor corporations. Bell-Sorensen received nothing from the debtor corporations except patent rights and what remained of the $23,700.00 after the Trustee in Bankruptcy paid general creditors of the three debtor corporations 33⅓% of the amount of their claims as allowed and provided in the plan of reorganization approved by the bankruptcy court. The former bondholders of "Equity" received stock in Bell-Sorensen "in full and complete satisfaction and payment of their said claims." No "deficit carry-over" could possibly have followed from the old to the new reorganized company from the standpoint of accounting, nor legally, as a consequence of the 77B proceedings.

Despite factual differences between the reorganization involved in the **Kavanagh** case and the reorganization of the Frisco, this court does accept defendant's assertion that **Kavanagh** is a relevant decision. The latter case does represent a holding, in the context of a bankruptcy reorganization whereby the interest of the former stockholders was eliminated, that no deficit in earnings and profits was carried over.

Kavanagh v. United States, *supra*, was held to be controlling in **Dunning v. United States**, 232 F. Supp. 915,

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[9] *Helvering v. Cement Investors, Inc.*, is discussed, *infra*.

920 (W. D. Mo. 1964). Like **Kavanagh**, the **Dunning** case involved a reorganization under section 77B of the Bankruptcy Act[10] (which did not qualify as a nontaxable "reorganization"[11]). In **Dunning v. United States**, the district court (1) pointed out that **Kavanagh** should not be construed as resting solely upon the finding that no deficit in earnings and profits had been proved, and (2) refused to extend the **Sansome**[12] rule so as to permit, in a bankruptcy reorganization, the carryover of a deficit.[13] 232 F. Supp. 915, 921.

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[10] Bankruptcy Act, § 77B, ch. 424, 48 Stat. 912 (1934), as amended. See note 8, *supra*.

[11] Regarding the question of nontaxable "reorganization," § 112 (g) (1) of the Revenue Act of 1936, ch. 690, 49 Stat. 1681, was applicable.

[12] *Commissioner v. Sansome*, 60 F. 2d 931 (2d Cir.) *cert. denied*, 287 U. S. 667 (1932), involved a reorganization whereby corporation A sold all of its assets to a new corporation, B. Corporation B assumed A's liabilities and the stock of B was distributed to the shareholders of A. The court of appeals held that the earnings of A carried over to B.

In *Commissioner v. Phipps*, 336 U. S. 410 (1949), the Supreme Court explained that *Sansome* was not based upon continuity of interest, but on the need to prevent the escape of earnings and profits from taxation. The Court held, with regard to the tax-free liquidation of five subsidiaries, that the net deficit of earnings and profits of the subsidiaries did not carry over to the parent. The parent had accumulated earnings and profits.

[13] *Dunning v. United States, supra*, the court rejected the reasoning of *United States v. Snider*, 224 F. 2d 165 (1st Cir. 1955). In the latter case, it was held, regarding a tax-free "reorganization," that a deficit in earnings and profits did carry over to the transferee, a newly formed corporation. In *Snider*, the First Circuit relied upon the fact that, at the time of the reorganization, none of the business entities involved possessed accumulated earnings and profits.

Without regard to the validity of the reasoning in *Snider*, this court agrees with defendant in the instant case that *Snider* is materially distinguishable. First, the shareholders of the transferor (a Massachusetts real estate trust) became the owners of the transferee. Secondly, the reorganization in *Snider* was not in connection with bankruptcy.

Although this court does not necessarily concur in all the reasoning expressed in **Banister v. United States,** *supra*, we are in complete agreement with the result reached in that case. We are of the opinion that, as contended by defendant, the elimination of the former Frisco shareholders, through the recapitalization, had crucial importance with regard to the question of deficit carryover.[14]

A case upon which plaintiffs place reliance is **United States v. El Pomar Investment Co.,** 330 F. 2d 872 (10th Cir. 1964). **El Pomar** involved two tax-free reorganizations, the first of which occurred in 1920. The bondholders of corporation A purchased A's property at a foreclosure sale and then transferred the property to a new corporation, B. In exchange, the bondholders of A received from corporation B bonds and all of B's stock. No shares in B were distributed to the A shareholders as such. At the time, corporation A had an aggregate deficit of approximately 1.2 million dollars.

It developed subsequently that corporation B was unable to pay the principal and interest of its bonds. As a result, the second reorganization took place. The bond-

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[14] Defendant contends that neither accumulated earnings and profits nor a deficit in earnings and profits survives a bankruptcy reorganization where the old stock is extinguished. One case which defendant cites in support of this proposition is *F. R. Humpage,* 17 T. C. 1625 (1952). In *Humpage,* the Tax Court rejected the Government's assertion that, in a § 77B reorganization, the accumulated earnings and profits of the debtor corporation survived and were transferred to the new corporation. The shareholders of the old corporation received no equity in the new one. The Tax Court reasoned that, under the "full priority doctrine" (*cf. Helvering v. Cement Investors, Inc, supra*), the bondholders of the old corporation obtained the beneficial ownership of its assets prior to the transfer to the new corporation. Thus, in effect, the earnings of the old corporation were distributed to the bondholders at that time. As a result, there could be no transfer to the new corporation of the accumulated earnings. Four of the Tax Court Judges dissented, holding that the *Sansome* rule was applicable.

holders of B obtained B's property through foreclosure sale. A new corporation, C, was formed and B's property was transferred to C in exchange for C's stock. All of the stock was then distributed to B's bondholders. Corporation B had, at the time of the reorganization, an accumulated deficit of approximately 2.9 million dollars. The court of appeals held that a sufficient deficit did carry over to corporation C, so that certain subsequent distributions to the shareholders of C were the return of capital. 330 F. 2d at 884-5.

In support of its decision, the court of appeals stated that the purpose of the rule of **Sansome** and **Phipps**[15] was to prevent the avoidance of tax through use of tax-free reorganizations. Then, the court declared the **Sansome-Phipps** rule to be inapplicable to the reorganizations being considered, since, in the opinion of the court, the respective reorganizations were not carried out in order to avoid tax. Finally, the court found it necessary to distinguish the **El Pomar** situation from that of **United States v. Kavanagh**, *supra*. One ground of distinction was the fact that the reorganizations in **El Pomar** were tax-free and were accomplished without judicial supervision. **Kavanagh**, on the other hand, involved a reorganization under section 77B of the Bankruptcy Act. Another stated difference was the fact that in **El Pomar**, "* * * on the second reorganization all of the stockholders of the predecessor corporation became stockholders of the successor corporation, resulting in a continuity of stock ownership."[16] 330 F. 2d at 884.

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[15] See note 12, *supra*.

[16] The court of appeals acknowledged that, regarding each reorganization in *El Pomar*, "technically" the foreclosure wiped out the interests of the stockholders of the respective predecessor corporations. 330 F. 2d at 876. Thus, the basis for the court's statement that, with regard to the second reorganization, there was continuity of stock ownership was the fact that, for the most part, the bondholders of corporation B (the predecessor in the second reorganization) also owned stock of B.

Defendant in the instant case contends that **El Pomar** should be limited to a holding that in the second reorganization there, the deficit of the second corporation (*i. e.*, B) carried over to the third corporation (*i. e.*, C). Defendant points out that, without regard to any deficit carryover from A to B (that is, in the first reorganization), the deficit of B was sufficient to offset the accumulated earnings and profits of the third corporation, C. Defendant accepts the view that the second reorganization in **El Pomar** did not result in the extinguishment of the interest of the prior stockholders. Thus, by means of this interpretation, defendant attempts to harmonize the result in **El Pomar** with the position of defendant in the case at bar as to the effect of eliminating the equity of former shareholders.

In the instant case, **El Pomar** is one of the decisions upon which plaintiffs base their contention that the Frisco deficit in earnings and profits survived the January 1, 1947, reorganization.[17] There are material factual differences between the situation in **El Pomar** and that of the case at bar. Moreover, this court does not accept plaintiffs' analysis, founded in part upon **El Pomar**, of the legal tests relevant to the matter of deficit carryover. It is correct, as plaintiffs point out, that the Frisco recapitalization qualified as a "reorganization" under section 112 (g) (1) of the Internal Revenue Code of 1939,[18] and that the original corporation continued to exist. However, neither of these factors can in itself be decisive. In the opinion of this court, the greatest difficulty with plaintiffs' analysis is the proposition that, had no reorganization

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[17] Another of the cases relied upon by plaintiffs is *Wisconsin Central R. R. Co. v. United States*, 155 Ct. Cl. 781, 296 F. 2d 750 (1961) *cert. denied*, 369 U. S. 885 (1962). This case dealt with the carryback of a net operating loss.

[18] Int. Rev. Code of 1939, § 112 (g) (1), as amended, ch. 247, § 213 (b), 53 Stat. 870 (1939), as amended.

occurred, the deficit would have been used to cancel accumulated earnings and profits. In their brief (p. 24), plaintiffs argue:

> * * * had Frisco's reorganization not taken place, clearly the corporate distributions here in question would not have been made out of accumulated earnings and profits. In consequence, * * * had no reorganization occurred, the tax attribute in question, a deficit in accumulated earnings and profits, would have served the same purpose as is here claimed * * *. In brief, under all the tests laid down by the Supreme Court and this tribunal, Frisco's January 1, 1947, tax-free recapitalization worked no change in its accumulated earnings and profits.

Evidently, plaintiffs ask us to assume that the following events might have occurred: (1) no receivership or bankruptcy reorganization of the Frisco ever took place; (2) as of December 31, 1946, the Frisco had a deficit of 51 million dollars; and (3) somehow, in the following years, the Frisco was able to surmount its financial difficulties and to acquire accumulated earnings and profits against which the deficit would be applied. Perhaps, our statement of the hypothetical situation is not a fair characterization of plaintiffs' assertion, but, in any event, we find little value in speculating as to what might have happened taxwise if the Frisco had not undergone reorganization. The fact of the matter is that the state of the Frisco's business and its financial condition were such that reorganization under section 77 of the Bankruptcy Act was required and was accomplished. The crucial considerations regarding the question of deficit survival are, in the opinion of this court, the nature of the reorganization and the consequent alteration of the railroad's financial situation.

As indicated previously, the interest of the pre-reorganization stockholders was found to be worthless and was

completely eliminated. The former stockholders as such received no part of the ownership of the reorganized corporation. Thus, their investment which had been represented by stock with face value totaling more than $114,000,000 would no longer be reflected upon the books of the Frisco.[19]

Not only did the reorganization affect the position of the former stockholders and the former unsecured creditors, but it also worked fundamental changes in the relation of the Frisco to its secured creditors. In order to achieve the purposes of the reorganization, substantial modification of the secured indebtedness took place. A corporation which, as of December 31, 1946, had obligations for principal in the amount of $269,119,202 and for accrued interest in the amount of $101,442,452 emerged from the reorganization with a total capitalization of $251,628,494. The former secured creditors accepted in full satisfaction of their claims new stock and securities in the amount of $251,628,494. No other debts or liabilities were reflected on the new books of the corporation, as of January 1, 1947. In view of these facts, we consider the position of the plaintiffs that the (receivership and) reorganization had no effect upon the Frisco's earnings and profits account to be untenable. That the reorganization was successful is attested by the fact that, in the following years, the Frisco was able to make and accumulate earnings and profits. Clearly, the reorganization benefited the former secured creditors who thereby became the sole stockholders, as well as those like plaintiffs who would become stockholders in the future. Under these circumstances, we are not willing, in determining the question of deficit carryover, to disregard the effects of the reorganization. We are inclined to agree with the court in **Banister**, *supra*,

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[19] *Cf.* Testa, "Earnings and Profits" after Bankruptcy Reorganization, 18 Tax L. Rev. 573 (1963).

that, under plaintiffs' view, the Frisco would be in a position of "having its cake and eating it too."

Furthermore, as indicated in our discussion of **Banister v. United States**, *supra*, this court accepts defendant's assertion that the recapitalization of the Frisco eliminated the deficit in earnings and profits. One argument put forth by defendant is that, when the former stockholders were eliminated, the deficit in earnings and profits was in effect distributed or dissipated. Of course, there can be no "distribution" of a deficit in the same sense that positive earnings and profits can be distributed to stockholders. On the other hand, considering the relationship between the investment of the old shareholders and the deficit, we believe that the notion suggested by defendant is helpful in explaining the conclusion that there could be no carryover of the deficit in earnings and profits. As defendant indicates, this concept is similar to the reasoning of **United States v. Kavanagh**, *supra*, where the court held that a deficit did not survive a bankruptcy reorganization. Also, in all likelihood, as defendant asserts, the fact that the old stock became worthless led to a deduction for the former shareholders and such deductions can be attributed to the earnings and profits deficit.

Thus, this court holds that, upon completion of the Frisco reorganization, the preexisting deficit was wiped out. In making this determination, we do not attempt to state a general rule regarding the effect of "reorganizations" or recapitalizations upon deficits in earnings. Rather, our holding is limited to the circumstances of the Frisco reorganization.[20] As the court in **United States v. Kavanagh**, *supra*, found with respect to the reorganiza-

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[20] It should be noted that presently § 381 of the Int. Rev. Code of 1954 deals with the subject of carryovers in corporate acquisitions.

tion there in question, we hold that no deficit of the Frisco carried over either "legally" or "from the standpoint of accounting."[21] This result is, in our opinion, consistent with the principles enunciated in **Commissioner v. Sansome**, *supra*, note 12, and **Commissioner v. Phipps**, *supra*, note 12.

Our decision that the deficit in earnings and profits did not survive the reorganization is fatal to plaintiffs' action. (See finding 17 (i), *infra*.) Still, some mention should be given to the argument of plaintiffs that, if the receivership and reorganization proceedings had any effect upon earnings and profits, the effect was to reduce earnings and profits to zero as of November 1, 1932 (as opposed to January 1, 1947). Under this view, the deficit in earnings and profits which arose during the insolvency proceedings would carry over to the reorganized Frisco. The basis for plaintiffs' argument is the "full priority rule" which was expressed in **Helvering v. Cement Investors, Inc.**, 316 U. S. 527, 532 (1942), as follows:

> In case of reorganizations of insolvent corporations, the creditors have the right to exclude the stockholders entirely from the reorganization plan. When the stockholders are excluded and the creditors of the old company become the stockholders of the new, "it conforms to realities to date their equity ownership" from the time when the processes of the law were invoked "to enforce their rights of full priority." **Helvering v. Alabama Asphaltic Limestone Co.**, 315 U. S. 179. • • •

In **Helvering v. Cement Investors, Inc.**, the Supreme Court held that a certain reorganization under section 77B of

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[21] Defendant points out that, as of January 1, 1947, the Frisco opened a new set of books which reflected only the new stock and securities. No entry was made regarding earned surplus or deficit. Although corporate accounting practice is not decisive of the tax questions, it is one factor to be considered.

the Bankruptcy Act, although not a "reorganization" under section 112 (g) (1) (B) or section 112 (g) (1) (C) of the Revenue Act of 1936, did constitute an "exchange" under section 112 (b) (5) of the Revenue Act of 1936.[22] The Court found that the creditors of the old company had an equitable interest in the property which was transferred to the new corporation.

In **Helvering v. Alabama Asphaltic Limestone Co.**, 315 U. S. 179 (1942) (cited in **Helvering v. Cement Investors, Inc.**, *supra*), and in subsequent cases, the "full priority doctrine" has been used to enable an insolvency reorganization to satisfy the test of "continuity of interest," a requirement for a tax-free "reorganization." That is, for purposes of "continuity," the Court permitted the ownership of the shareholders of the new corporation to relate back to the time when they, as the creditors of the old corporation, exercised their right of priority over the shareholders of the old corporation.[23]

This court does not accept the contention of plaintiffs that November 1, 1932, the date upon which the Frisco receivership was commenced, was the decisive date with regard to the alteration of the earnings and profits account. There is, in our opinion, no warrant for extending the "full priority rule" to the lengths which plaintiffs request. The recapitalization became effective on January 1, 1947, and that date must be considered as the time when the Frisco's earnings and profits became zero (*i. e.*, when the aggregate deficit of the years, 1933 through 1947, was eliminated).

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[22] Revenue Act of 1936, ch. 690, § 112, 49 Stat. 1678.

[23] It should be noted that the concept that the equitable ownership of creditors dates from the invoking of their creditors' rights has been used, in a different context, in such cases as *United States v. Kavanagh, supra,* and *F. R. Humpage, supra,* note 14.

As defendant points out, the bondholders of the Frisco did not actually become stockholders on November 1, 1932. In fact, it was largely because of the existence of the bonded indebtedness that the deficit in earnings and profits arose. That is, the deficit can be attributed to the deduction of interest which accrued on the bonds in the years subsequent to 1932. (See finding 14, *infra.*) The view of plaintiffs would have us disregard the actual financial situation and this we decline to do.

Since this court has already determined that plaintiffs cannot recover, we find it unnecessary to discuss the remaining questions.

In conclusion, we hold that the distribution which plaintiffs received from the Frisco in 1957 and 1958 were fully taxable as ordinary income. Absent a determination that the preexisting deficit in earnings and profits survived the completion of the reorganization, the Frisco had as of 1957 and 1958 sufficient accumulated earnings and profits so that the entire distributions would constitute dividends. This court has indicated its decision that the deficit did not survive. Accordingly, the tax benefit which plaintiffs seek to obtain must be denied. The amounts which plaintiffs received from the Frisco in 1957 and 1958 did not represent the return of capital, but, on the contrary, constituted a distribution of current and accumulated earnings and profits and were, therefore, taxable in their entirety as dividends.

Plaintiffs' petition is dismissed.

Findings of Fact.

The court, having considered the evidence, the report of Trial Commissioner Franklin M. Stone, and the briefs and argument of counsel, makes findings of fact as follows:

A. **Identity of Plaintiffs.**

1. Plaintiffs are husband and wife, residing at 5510 Waterman Avenue, Apartment 4, West, St. Louis 12, Missouri. Plaintiff John E. McCullough has been continuously employed by the St. Louis-San Francisco Railway Company (sometimes hereinafter referred to as "Frisco") since March 9, 1942.

2. For the years 1957 and 1958, plaintiffs timely filed joint Federal income tax returns on a calendar year basis in conformity with the cash basis of accounting.

B. **Earnings and Profits Issue.**

3. In 1955, Plaintiff John E. McCullough acquired 35 shares of the common stock of the Frisco as a bonus from his employer. Plaintiffs purchased an additional 65 shares of said stock on January 2, 1957, and an additional 100 shares of said stock on October 18, 1957. The 35 shares of said stock acquired in 1955 and the 65 shares acquired January 2, 1957, were sold by plaintiffs on December 18, 1957. During the years 1956 through 1958, plaintiffs received distributions from the Frisco on their Frisco stock as follows: 1956, $70.00; 1957, $187.50; and 1958, $25.00. The parties stipulated that the plaintiffs have no right to recover for the year 1956, for the reason that an appropriate claim for refund was not timely filed.

4. All of the distributions listed in finding 3, *supra*, were included as dividend income in plaintiffs' Federal income tax returns for the years in which such dividends were received, and Federal income tax (which has never been refunded) was duly paid thereon by plaintiffs.

5. The Frisco was incorporated under the laws of the State of Missouri on August 24, 1916, and commenced business as of November 1, 1916. It is engaged as a common carrier in the business of transporting persons and property by rail in Missouri and, directly and through subsidiaries, in eight other states. Its principal office is located at 906 Olive Street, St. Louis 1, Missouri. At all times the Frisco has filed its Federal income tax returns on a calendar-year basis in conformity with the accrual basis of accounting.

6. For purposes of this proceeding, the parties are in agreement that as of December 31, 1932, the Frisco had post-March 1, 1913, accumulated earnings and profits, in an amount which remains to be computed under Rule 47 (c) (2), if necessary. A balance sheet filed by Frisco with the Interstate Commerce Commission as of December 31, 1932, is quoted below:

St. Louis-San Francisco Railway Co.
Balance Sheet as Submitted to Interstate Commerce Commission as of December 31, 1932

Assets

Investments:		
Investment in road and equipment	$421,649,579	
Deposits in lieu of mortgaged property sold	6,926	
Miscellaneous physical property	234,535	
Investment in affiliated companies	33,211,318	
Other investments	11,629,100	
Total investments		$466,731,459
Current assets:		
Cash	3,005,339	
Other current assets	5,591,648	
Total current assets		8,596,987
Deferred assets		217,462
Unadjusted debits		1,925,088
Total assets		477,470,996

St. Louis-San Francisco Railway Co.—Continued

Balance Sheet as Submitted to Interstate Commerce Commission as of December 31, 1932—Continued

Liabilities, Capital and Surplus

Current liabilities		$ 24,368,239
Deferred liabilities		154,225
Unadjusted credits:		
Tax liability	$ 2,551,382	
Accrued depreciation—road	985,187	
Accrued depreciation—equipment	37,984,012	
Accrued depreciation—miscellaneous physical property	1,848,664	
Total unadjusted credits		43,369,245
Long term debt		289,125,767
Capital stock		114,701,526
Surplus		5,751,995
Total liabilities, capital and surplus		477,470,996

St. Louis-San Francisco Railway Co.

Balance Sheet, Dec. 31, 1932

Schedule—Loans and Bills Payable

Obligation	Maturity date	Amount
Merc. Commerce Bk. & Tr. Co., St. Louis	7-1-32	$ 402,113
Guaranty Trust Co. of N. Y.	7-1-32	1,042,894
First National Bank of St. Louis	7-1-32	342,984
Bankers Trust Co. of N. Y.	7-1-32	422,811
Central Hanover Bk. & Tr. Co., N. Y.	7-1-32	433,469
The Railroad Credit Corp.	Demand	2,805,175
Reconstruction Finance Corp.	Demand	1,800,000
Reconstruction Finance Corp.	Demand	3,390,000
The Railroad Credit Corp.	Demand	1,000,000
Chase National Bank of N. Y.	12-31-32	2,492,592
Total		14,132,038

St. Louis-San Francisco Railway Co.

Balance Sheet, Dec. 31, 1932

Schedules Appended to Balance Sheet

Unmatured Funded Debt

Obligation	Maturity rate	Interest rate	Par value outstanding
		Percent	
St. L.-S. F. Ry. Co. prior lien mtge.:			
Series A	7-1-50	4	$ 91,887,097
Series B	7-1-50	5	25,561,500
St. L. S. F. Ry. consolidated mtge.:			
Series A	3-1-78	4½	108,305,000
Series B	6-1-36	6	10,000,000
KCFS & M Ry. Co. Refdg. mtge.	10-1-36	4	25,835,000
KCM & B R. R. Co. General mtge.	3-1-34	4	3,323,390
KCM & B R. R. Co. Income mtge.	3-1-34	5	3,182,780
St. L.-S. F. Ry. Co. Trust mtge. of 1887	10-1-87	5	4,000
Springfield General Office Building Notes	1936	6	80,000
Equipment obligations			20,947,000
Total			289,125,767

7. On November 1, 1932, Hobbs Western Company, a creditor of the Frisco, filed a Bill of Complaint against the Frisco in the United States District Court for the Eastern District of Missouri, Eastern Division (hereinafter referred to as "the Court"), seeking the appointment of a receiver. The Bill of Complaint alleged, *inter alia*, that the Frisco was in default on an obligation due to plaintiff for supplies furnished, and that the Frisco would be unable to pay its other debts, secured and unsecured, as they matured. A schedule of the Frisco's obligations was annexed to the Bill of Complaint. In its answer, also filed on November 1, 1932, the Frisco admitted each and every allegation in the Bill of Complaint and joined in the prayer for appointment of a receiver. By order dated November 1, 1932, the Court appointed James M. Kurn as receiver, and John G. Lonsdale was appointed as co-receiver by order of November 5, 1932. The Frisco's properties were operated by said co-receivers until October 1, 1933.

8. On May 16, 1933, the Frisco filed a petition in the Court (identified in finding 7, *supra*) for the institution of bankruptcy reorganization proceedings. The Frisco set forth in that petition certain data with respect to its financial situation, i. e., its liquid assets, its current interest and rental obligations, and its current income. However, the Frisco did not set forth a valuation of its assets. The Frisco alleged in said petition:

> The income of the Debtor from its operations as a common carrier and other sources has thus been reduced below the amount necessary to enable the Debtor to pay its costs of operation and to meet its fixed charges. Because of its earnings and of the general economic conditions, the Debtor is unable to secure funds by the sale of its bonds to the public or otherwise, and it has neither the money nor the ability to borrow funds necessary to meet its require-

ments above mentioned already matured or maturing in the immediate future. Accordingly, the Debtor is unable to meet its debts as they mature and desires to effect a plan of reorganization in accordance with Section 77 of the Act of Congress of July 1, 1898, entitled "An Act to Establish a Uniform System of Bankruptcy throughout the United States," as amended.

The petition further recited that a Plan and Agreement of Readjustment (hereinafter referred to as the "Plan") designed to effect a substantial reduction in the Frisco's fixed interest charges had been approved by the Frisco's Board of Directors and stockholders, by committees representing the several classes of securities outstanding, and by the Interstate Commerce Commission. More particularly, the petition recited that creditors consenting to the Plan represented more than 68 percent of each issue of bonds affected and more than 71 percent of the total of such issues.

The Plan was also approved by five leading banking institutions which had participated in the issue and distribution of the Frisco's securities, namely: Chase Securities Corp.; Dillon, Reed & Co.; Speyer & Co.; J. & W. Seligman & Co.; Guaranty Co. of New York; and by four leading insurance companies with large holdings of Frisco's bonds, namely: The Metropolitan Life Insurance Co.; the Prudential Insurance Co. of America; Aetna Life Insurance Co.; and John Hancock Mutual Life Insurance Co. After approval by the Interstate Commerce Commission, in 1932, the Reconstruction Finance Corporation and the Railway Credit Corporation (both Federal agencies) loaned to the Frisco the sum of $4,390,000 which was secured by a pledge of the Frisco's consolidated mortgage bonds. (See **In re St. Louis-San Francisco Railway Co.**, 46 F. Supp. 120, 130 (E. D. Mo. 1942).)

The above-mentioned petition stated with respect to the Plan that "This should solve the financial problems of the Railway Company."

Under this Plan, in return for the issuance by the Frisco to its security holders of additional shares of Frisco preferred and common stock, part of the interest on some of the Frisco's securities was to be postponed, and the maturity dates of some of its obligations were to be extended. In addition, unsecured creditors were to receive notes. But the face values of the outstanding obligations were not to be reduced and the existing shares of preferred and common stock were to remain outstanding as before. The existing shareholders also were entitled to subscribe for the additional shares at a stated price, in which case the bondholders would receive cash instead of shares. The Plan set forth an "illustrative table * * * to show the operation of the Plan, beginning with 1933 on the basis of assumed earnings as indicated below."

	Assumed income available for interest	Available net income after fixed charges
1933	$ 5,000,000	$ 1,600,000
1934	7,500,000	4,240,000
1935	10,000,000	6,450,000
1936	15,000,000	11,690,000
1937	20,000,000	14,875,000
1938	23,000,000	15,930,000
1939	23,000,000	16,350,000
1940	23,000,000	13,390,000
1941	23,000,000	12,315,000

In December 1936, the 1933 Plan was submitted to the Interstate Commerce Commission (hereinafter sometimes referred to as the "I. C. C." or the "Commission") for final approval under Section 77 of the Bankruptcy Act, and it was disapproved in a report dated March 17, 1937, the earnings available for interest from 1933 through 1936 having turned out to be substantially below those projected in the 1933 Plan. The Frisco's Chairman of the Board testified during the course of the proceedings

before said Commission that in his opinion recovery was in process but that it had not gone far enough to enable establishing of a standard by which the Frisco's earning power could be measured for the future. He urged postponement of consideration of any plan by the I. C. C. until a clearer picture of its earning power was established. (See **St. Louis-S. F. Ry. Co. Reorganization**, 221 I. C. C. 199.)

9. (a) By order entered on May 17, 1933, the Court approved Frisco's said petition as properly filed under Section 77 and complaint with the requirements thereof for institution of bankruptcy reorganization proceedings. The Court directed that, until further order appointing a trustee or trustees, the co-receivers, James M. Kurn and John G. Lonsdale, should continue to preserve, manage, maintain and operate the Frisco's properties. Subsequently, the above-named co-receivers died, and the Court appointed Frank A. Thompson as sole trustee. After the original Plan was disapproved by the I. C. C. in 1937, other plans were proposed in 1937 and 1938, which were approved by the I. C. C. in July 1940, and modified later in 1940, in 1944, and on November 15, 1945. The plan confirmed in 1945 and finally consummated in 1947 (see (b), *infra*) followed the general outline of the one approved in 1940, but was modified in the intervening years in the following respects:

(i) The bonds of the Kansas City, Memphis & Birmingham RR. Co., having a total face value of $6,506,170, were finally paid in cash rather than in securities of the Frisco, as originally approved in 1940.

(ii) Claims of the Reconstruction Finance Corp. and the Railroad Credit Corp., in the respective amounts of $7,359,533 and $3,691,060 (as of 1940), were compromised in 1943 for cash payments and forgiveness of $3,021,158 of the accrued interest, rather than for bonds and pre-

ferred and common stock of the Frisco, as originally approved.

(iii) Mortgage claims of bondholders of the Kansas City, Fort Scott & Memphis Ry. Co. in the principal amount of $25,835,000 and accrued interest of $6,458,750 (as of 1940), received securities to the extent of $21,-455,967 and cash for the balance, instead of receiving only bonds and preferred stock, as approved in the 1940 plan.

(b) Pursuant to the plan of reorganization confirmed by the Court on November 15, 1945, the Company was reorganized effective January 1, 1947. On that date, the properties of the Debtor were transferred by the trustee to the reorganized corporation, pursuant to the plan of reorganization. The Frisco has continuously owned and operated such properties since January 1, 1947.

10. As of December 31, 1932, the Frisco had approximately $303,000,000 in debt securities outstanding. With minor reductions, those securities were outstanding during the entire period of the receivership and reorganization proceedings. Interest matured and was accrued on such outstanding securities during the period of the receivership and reorganization proceedings in the aggregate amount of approximately $180,900,000, and such interest was deducted in the computation of net income subject to Federal income tax returns filed during the reorganization period in the names of the receivers, trustees or trustee, followed by "St. Louis-San Francisco Railway Company, Debtor." Of that amount, approximately $3,000,000 was cancelled in 1943, and approximately $76,500,000 was paid to the security holders in cash prior to, or contemporaneously with, the effective date of the reorganization. The parties are agreed that, if necessary, any or all of the approximate figures set forth in this paragraph shall be reduced to exact amounts by computations under Rule 47 (c) (2).

11. Prior to its reorganization as of January 1, 1947, the Frisco had outstanding common stock with an aggregate face value of $65,543,226, and preferred stock with the aggregate face value of $49,158,300. As of December 31, 1946, the Frisco's general unsecured creditors held claims totaling $250,000. Under the terms of the reorganization plan, as approved by the Interstate Commerce Commission and the courts, such outstanding common and preferred stock, totaling more than $114,000,000 in face value, was eliminated and cancelled as worthless; and the claims of unsecured creditors totaling $250,000 were likewise cancelled as worthless. The holders of the several classes of indebtedness received new bonds, preferred stock and cash, and the previously outstanding indebtedness was cancelled. Such new stocks and securities were received by the old creditors in full and complete satisfaction of their claims against the debtor. The following tabulation shows the effect of the reorganization:

St. Louis-San Francisco Railway Co.

Outstanding Long Term Debt, Interest and Stock; and Securities Issued and/or Assumed by Reorganization Company, Jan. 1, 1947

Obligations and stock	Securities issued prior to reorganization: Principal amount Dec. 31, 1946	Accrued interest unpaid Dec. 31, 1946	Total claims as of Dec. 31, 1946	Securities issued by reorganized company: First mortgage bonds series A, 4% (50 years)	Second mortgage income bonds, series A, 4½% (75 years)	Preferred stock series A, 5% (par value $100 per share)	Common stock (no par value, stated value $50 per share)	Obligations assumed undisturbed	Total capitalization
Old secured obligations:									
Equipment trust obligations	$ 6,772,000	.....	$ 6,772,000	.....	.....	.....	.....	$6,772,000	$ 6,772,000
The Kansas City Fort Scott & Memphis Ry. Co. refdg. 4% bonds of 1936	21,456,742	$ 93	21,456,835	$18,937,055	$ 2,518,912	.....	.....	.....	21,455,967
Prior lien mtge. bonds, series A, 4% of 1950	91,887,096	34,922,561	126,809,657	20,123,274	19,589,410	$30,506,516	$30,644,347	.....	100,863,547
Prior lien mtge. bonds, series B, 5% of 1950	25,561,500	12,768,481	38,329,981	5,955,830	5,798,626	9,023,210	9,074,332	.....	29,851,998
Consolidated mtge. bonds, series A, 4½% of 1978	108,305,000	45,456,677	153,761,677	23,935,405	16,571,748	18,845,070	18,845,070	.....	78,197,293
Consolidated mtge. bonds, series B, 6% of 1936	10,000,000	6,076,500	16,076,500	2,430,000	1,685,200	1,910,000	1,915,000	.....	7,940,200
Bank loans, 6% of 1932*	5,136,863	2,218,140	7,355,003	2,003,778	1,389,615	1,574,986	1,579,109	.....	6,547,488
Total	269,119,202	101,442,452	370,561,651	73,385,342	47,553,512	61,859,782	62,057,858	6,772,000	251,628,494
Old stock and unsecured debt:									
Common stock	$ 65,543,226								
Preferred stock	49,157,400								
Preferred stock, series A	900								
General unsecured creditors	250,000								
Total old stock and unsecured debt	114,951,526								
Totals—Old claims v. new capitalization	485,513,177								$251,628,494

Equities of the holders of these stock and general unsecured creditors were found to be of no value.

* Bank loans of 1932, principal amount Dec. 31, 1946:

Chase National Bank	$2,492,592
Guaranty Trust Co.	1,042,894
Central Hanover Bk. & Tr. Co.	433,469
Bankers Trust Co.	422,811
Mercantile-Commerce Bk. & Tr. Co.	402,115
First National Bk. of St. Louis	342,984

12. Incident to the reorganization, the Frisco's Articles of Association were amended in the following respect:

(i) The original articles provided that the railroad should maintain and operate 31 different lines (Art. III) and that the length of the road should be in the State of Missouri 1,332 miles, and, in the aggregate, 3,467 miles (Art. IV).

The Certificate of Amendments provided that the railroad should operate 57 different lines, of which 6 could be leased, and that the corporation also should have the power to acquire, maintain and operate other lines and properties without limitation; and that the length of the road in the State of Missouri was 1,470 miles, and, in the aggregate, 4,639 miles.

(ii) The original Articles (Arts. VI and VII) provided that the capital of the company amounted to $450,000,000, consisting of 2,000,000 shares of preferred stock and 2,500,000 shares of common stock, both classes of stock having a par value of $100 per share. The preferred stock was to carry a dividend rate of up to 7 percent but was not to be cumulative, and the amount of preferred stock was not to be increased without the consent of a majority of the stockholders of both classes of stock.

The Certificate of Amendment (at Art. VII) provided that "all of the capital stock of the Corporation, both preferred stock and common stock, authorized immediately prior to these Amendments, * * * is hereby cancelled and abolished." It authorized the issuance of entirely new shares consisting of 1,500,000 shares of preferred stock having a par value of $100 each, and 6,000,000 shares of common stock without par value. One million two hundred forty-one thousand one hundred fifty-three (1,241,153) shares of the common stock were to be issued pursuant to the Reorganization Plan; 1,237,194 shares were to be reserved for eventual conver-

sion of the new preferred stock; and 1,426,494 shares were to be reserved for eventual conversion of the second mortgage income bonds to be issued upon the reorganization. The new preferred stock was to carry 5 percent dividends, but they were not to be cumulative, except to the extent provided in a particular series. Series A preferred stock, to the extent of 618,597 shares to be issued forthwith as contemplated by the Plan of Reorganization, was to have cumulative dividends but only to the extent that there was available net income, and the stock was convertible at the option of the holder into shares of common stock at the rate of two shares of common stock for each share of preferred.

13. The reorganized company (the Frisco) opened a new set of books as of January 1, 1947, with Journal Entry No. 1 dated January 1947, reflecting the obligations and securities assumed. No entries were made on either the old or the new books with respect to the prior obligations, defaulted interest accruals, and stock; they were merely left outstanding on the old books.

14. At all times in question, the Frisco has computed its income according to the accrual method of accounting. In its income tax returns for each of the years 1933 through 1941, the Frisco reported net losses after accruing interest on its long-term debt. It reported net income for each of the years 1942 through 1946; but due to the prior losses during the years 1933-1941, the company reported aggregate losses (as adjusted in some years by the Internal Revenue Agent on audit) during the entire period of reorganization of $50,958,026.90. Because of adjustments necessary to arrive at the earnings and profits, the parties agree that the amount of the deficit in earnings and profits for purposes of this case is to be determined under a Rule 47 (c) (2) computation, if necessary. The income tax returns of the Frisco for the years

1931-1939 were accepted as filed by the Commissioner of Internal Revenue (hereinafter sometimes referred to as the "Commissioner") without any audit or report by an Internal Revenue Agent. The returns of the Frisco for the years 1940 through 1946 were examined by the Commissioner, and interest accrued on its debt obligations was allowed as a deduction for each such year.

15. Set forth below is a tabulation submitted by the Frisco to the Interstate Commerce Commission, showing the income of the Frisco available for payment of interest on indebtedness each year from 1923 through 1946, the interest requirements, the amounts actually paid, and in column (g) the remaining income:

St. Louis-San Francsco Railway Co.

Net Income per Reports to I. C. C. Before and After Interest Accruals, Interest Requirements, Interest Payments, and Interest Unpaid 1923 to 1946, Inclusive

	(a) Income available for payment of interest per reports to I. C. C.	(b) Interest requirements Income account	(c) Interest requirements Property account	(d) Canceled interest P & L	(e) Interest payments	(f) Interest unpaid	(g) Remaining income per reports to I. C. C.
Balance 1-1-23	.....	.....	.....	.....	.....	$ 7,367,524	.....
1923	$ 14,735,446	$ 12,042,132	$ 173,586	.....	$ 12,942,862	6,640,380	$ 2,693,314
1924	17,424,672	12,433,289	.....	.....	12,436,294	6,637,375	4,991,383
1925	18,198,809	12,478,488	.....	.....	12,503,751	6,612,112	5,720,321
1926	18,788,484	12,969,788	25,426	.....	12,794,863	6,812,463	5,818,696
1927	19,183,944	13,018,563	.....	.....	13,073,287	6,757,739	6,165,381
1928	33,434,102	14,280,703	35,072	.....	15,772,868	5,300,646	19,153,399
1929	22,686,912	12,441,418	.....	.....	12,598,981	5,143,083	10,245,494
1930	19,438,008	12,705,071	31,042	.....	12,554,177	5,325,019	6,732,937
1931	10,689,515	13,161,579	.....	.....	13,286,128	5,200,470	(2,472,064)
1932	4,443,917	13,424,035	.....	.....	12,990,845	5,633,660	(8,980,118)
1933	4,062,120	13,357,824	.....	(A) $45,756	497,102	18,448,626	(9,295,704)
1934	3,579,657	13,163,647	.....	.....	1,058,528	30,553,745	(9,583,990)
1935	2,516,461	13,002,194	.....	.....	624,035	42,931,904	(10,485,733)
1936	6,232,025	12,897,524	.....	.....	1,385,139	54,444,289	(6,665,499)
1937	5,073,167	12,829,828	.....	.....	1,329,835	65,944,277	(7,756,656)
1938	1,266,679	12,741,451	.....	.....	1,492,780	77,192,948	(11,474,772)
1939	3,923,090	12,677,207	.....	.....	3,260,926	86,609,229	(8,754,117)
1940	5,467,775	12,614,378	.....	.....	645,335	98,578,272	(7,146,603)
1941	12,026,628	12,549,858	.....	.....	562,913	110,565,217	(523,230)
1942	25,837,087	12,470,463	12,805	.....	18,982,390	104,066,095	13,366,624
1943	22,537,463	11,869,735	.....	(B) 3,021,158	15,099,571	97,815,101	10,667,728
1944	17,487,487	11,830,006	.....	.....	11,909,306	97,735,801	5,657,481
1945	12,911,120	11,775,089	.....	(27)	10,987,644	98,523,273	1,136,031
1946	13,925,589	11,673,340	20,345	.....	(C) 8,774,506	101,442,452	2,252,249
	315,870,157	304,407,605	298,276	3,066,887	207,564,066	.....	11,462,552

Column (f)—Interest unpaid at beginning of year plus columns (b) and (c) minus columns (d) and (e).
Column (g)—Column (a) minus column (b).
Note (A)—Adjustment of interest matured prior to 11-1-32.
Note (B)—Adjustment of interest liability to R. F. C. and R. C. C. per settlement under Court 383A dated Oct. 14, 1943.
Note (C)—Includes $7,618,974 covering balance in Accounts 762 and 766 due security holders, authorized paid under Court Order during the receivership period. Of this amount $6,833,326 was authorized paid by Court Order 551 dated Dec. 12, 1946, and was deposited in various banks in December 1946. Liability and deposit accounts with various banks were transferred to the reorganized company at Jan. 1, 1947.

However, the amounts listed above as remaining income do not necessarily reflect the amounts to be taken into account in determining earnings and profits.

16. The parties stipulated, solely for the purpose of this case, that in each of the years 1957 and 1958, distributions made to stockholders as such, exceeded Frisco's current earnings and profits for those years, and that the amount by which such distributions exceeded current earnings and profits may be determined pursuant to Rule 47 (c) (2), if necessary.

17. The parties stipulated as follows with respect to the consequences flowing from various possible rulings herein by the Court:

(i) If it be determined that the Frisco, by reason of its reorganization effective as of January 1, 1947, had zero earnings and profits at December 31, 1946, then the Frisco, as of December 31, 1955, had accumulated and current earnings and profit sufficient to cover all distributions during the years in suit subsequent to that date, and plaintiffs have no right to recover under this issue.

(ii) If it be determined: (a) that by reason of the Frisco's 1932 equity receivership and its reorganization proceedings from 1932 through 1946, the Frisco's earnings and profits must be deemed to be zero at the beginning of the receivership or reorganization proceedings; (b) that the aggregate deficit from 1932 or 1933 through 1946 survived the completion of the reorganization; and (c) that the deficit should not be reduced by the disposition as of January 1, 1947, of the accrued and unpaid interest, then the Frisco had a deficit in accumulated earnings and profits at the beginning of each of the years 1956, 1957, and 1958, the amount of such deficit to be determined pursuant to Rule 47 (c) (2), if necessary.

(iii) If the deficits in earnings and profits incurred during the period of the receivership and bankruptcy properly should be taken into account in determining the accumulated earnings and profits of the Frisco at January 1, 1957, and January 1, 1958, and if interest accrued on obligations of the Debtor which were discharged on January 1, 1947, at the termination of the reorganization properly should be included in the computation of such deficits, then the parties are in agreement, for the purposes of this case only, that certain portions of the distributions in those years are not taxable as dividend income to the plaintiffs, the exact amount of which shall be determined pursuant to Rule 47 (c) (2).

(iv) If this court should determine that the deficit in earnings and profits arising during the course of the Debtor's receivership and trusteeship should be reduced, as of January 1, 1947, by the amount of the accrued interest on the obligations of the Debtor which obligations and accrued interest thereon were discharged under the reorganization plan by the exchange of stock and/or debt obligations of the Frisco, then the parties are in agreement that distributions received by the plaintiffs in 1957 and 1958 were fully taxable as dividend income and that plaintiffs have no right to recover.

18. In 1946 the reorganization managers of the Frisco applied to the Commissioner of Internal Revenue for a tax ruling as to certain Federal income tax consequences of the contemplated reorganization. The Commissioner issued his requested ruling letter to the applicants under date of February 28, 1947. In this letter the Commissioner first reviewed in detail the provisions of the Reorganization Plan, as submitted to him by the applicants, and then stated:

> Based upon the information submitted, it is held that the proposed change in capital structure of St.

Louis-San Francisco Railway Company will constitute a reorganization within the meaning of section 112 (g) (1) of the Internal Revenue Code; that the exchange of old bonds by the holders thereof for new bonds, cash and scrip, or new bonds and/or stock and scrip would qualify as a nontaxable exchange (section 112 (b) (3) of the Code) insofar as the new bonds and/or stock and scrip to be received in consideration for surrendering the old bonds themselves, if it were not for the fact that the property to be received in the exchange consists not only of property permitted by such paragraph but also money. Therefore under section 112 (c) (1) of the Code the gain, if any, to the recipient, shall be recognized, but in an amount not in excess of the sum of such money received in the exchange; that a portion of the bonds and/or stock and scrip to be issued in connection with the reorganization to the holders of old prior lien bonds, series A and B, and consolidated, series A and B, represents accrued and unpaid interest upon said old bonds; and that the cash paid or to be paid on the Fort Scott bonds, prior lien, series A and B, and consolidated, series A and B, as set forth in the plan of reorganization to be applied to interest constitutes interest income to the extent of the unpaid accrued interest. (Section 22 (a) of the Code.)

It is also held that where a bond of the debtor was purchased prior to the default in interest payments and bonds and/or stock and scrip are to be received in payment for such interest, the ratio of the unpaid accrued interest to the aggregate amount of the old obligation (face amount of the old bond plus the unpaid accrued interest thereon), multiplied by the market value, as of the effective date the plan is consummated, of the bonds and/or stock and scrip to be received, constitutes taxable interest income to

the old bondholders under the provisions of section 22 (a) of the Code, to the extent of the unpaid accrued interest; that where a bondholder purchased a bond "flat" when the interest on such bond was in default at the date of purchase and interest is received on said bond for the period transpired prior to the purchase thereof, such interest represents a return of capital; and that the interest received for the period subsequent to date of purchase represents interest income under section 22 (a) of the Code.

It is further held that the basis of the new bonds and/or stock and scrip shall be determined in accordance with section 113 (a) (6) of the Code; that upon the subsequent disposition of the new bonds, stock and scrip the cost or other basis of the old bonds should be apportioned among the new bonds, stock and scrip in proportion to their respective fair market values as of the effective date the reorganization is consummated; and that the settlement of the claims of the banks referred to above by the payment of cash and securities will constitute a taxable exchange, the gain or loss to be measured by the difference between the cost or other basis of said claims, and cash and the fair market value of the bonds and/or stock and scrip as of the effective date the organization is consummated.

19. On March 19, 1962, counsel for the Frisco requested a ruling from the Commissioner of Internal Revenue with respect to certain questions arising in connection with the computation of the accumulated earnings and profits of the company for the purpose of determining to what extent the stockholders' dividends were taxable. In his reply dated July 13, 1962, the Commissioner stated:

You ask whether interest accrued during the period that the property was held and operated by

receivers and by trustees in bankruptcy is a proper deduction in the determination of post-reorganization accumulated earnings and profits when such interest was never paid in cash.

You further ask, if such interest is held not to be a deduction, whether the amount of the interest which was paid in the form of new securities is a proper deduction in the determination of post-reorganization accumulated earnings and profits in view of the ruling letter dated February 28, 1947, addressed to Cravath, Swaine & Moore, 15 Broad Street, New York 5, New York (IT: R: B: Sec.—CTH). In the ruling it was held that a portion of the value of the new securities received by the old bondholders constituted taxable interest income to the bondholders. The holding with respect to interest in the ruling letter was invalidated by the decision in the case of **William W. Carman v. Commissioner**, B. T. A. 1029 (C. A. 2, 1951), 189 Fed. 2d 363. Therefore this holding with respect to interest is of no force or effect.

It is the position of the service that in situations where stockholders' interests are extinguished in whole or in part and the creditors become stockholders any earnings and profits or deficit in earnings and profits is also extinguished.

Based on the above facts and computations submitted it is held that as of January 1, 1947, the effective date of the reorganization, earnings and profits were zero. Since there was a sufficient amount of current earnings and profits or earnings and profits accumulated subsequent to January 1, 1947, it is held that all distributions paid from January 1, 1947 through December 31, 1960, were paid from earnings and profits and are taxable in their entirety as dividends.

20. In his report covering the years 1947 and 1948, the examining Revenue Agent prepared a balance sheet for the Frisco as of the end of 1946 and as of the beginning of 1947, i. e., just prior to, and just after, the reorganization. He made a number of adjustments on the assets side which decreased the amount of the total assets from $435,417,408.31 to $377,275,134.16. At the same time he made adjustments on the liability side which, among other things, reduced the liability for interest in default by $101,442,452.36. He also simultaneously increased unearned surplus by $90,855,536.49, and he further showed a deficit in unappropriated earned surplus, as of the beginning of 1947, of $94,519,478.54. The parties are in agreement that such balance sheet reflects only the views of the examining Agent, and does not estop the Commissioner of Internal Revenue, or the Government, from repudiating or changing any of the items, amounts, or computations set forth therein.

C. **Capital Loss Carryover Issue.**

21. On December 18, 1957, plaintiffs sold 100 shares of the common stock of the Frisco for a net consideration of $1,025.82. Such stock had been acquired by plaintiffs more than 6 months prior to the date of sale at a cost of $2,839.90.

22. The parties have agreed as follows with respect to the consequences flowing from possible rulings by the court:

(i) If it is determined that certain portions of the distributions received by plaintiffs with respect to said stock during 1956 and 1957 were not taxable as dividend income, then plaintiffs' adjusted basis therefor on December 18, 1957, was approximately $2,600.00, and that plaintiffs incurred a long-term capital loss in 1957 as a result of the sale of said stock in the approximate amount of $1,550.00, of which the excess thereof over

$1,000.00, is properly allowable as a deduction in determining plaintiffs' taxable net income for 1958, the precise amount to be determined under Rule 47 (c) (2), if necessary.

(ii) If it is determined that distributions received by plaintiffs with respect to said stock during 1956 and 1957 were taxable in their entirety as dividend income, then plaintiffs incurred a long-term capital loss in 1957 as a result of the sale of said stock in the amount of $1,814.08, of which $814.08 is properly allowable as a deduction in determining plaintiffs' taxable net income for 1958.

D. Taxes Paid by Plaintiffs.

23. Plaintiffs paid income taxes to the District Director of Internal Revenue, St. Louis, Missouri, for the years 1957 and 1958, as follows:

1957—$4,223.44
1958—$4,734.95

E. Refund Claims Filed by Plaintiffs.

24. Appropriate claims for refund on Form 843, covering both of the issues in this cause, were timely filed by plaintiffs on or about April 15, 1960, for the year 1958, and April 16, 1960, for the year 1957, with the District Director of Internal Revenue, St. Louis, Missouri. All such refund claims had been on file in excess of 6 months when this suit was instituted, and the reasons set forth in support of the said claims were substantially in accordance with the facts set forth herein.

25. This suit was timely instituted, i. e., more than six (6) months after the filing of the refund claims.

26. Plaintiffs are the sole owners of the claims here relied upon, and no assignment or transfer thereof, or any part thereof, or interest therein, has been made by plaintiffs.

27. The parties agree that the issues in this case for determination by the court may be limited to those relating to the right of the plaintiffs to recover, with the amount of recovery, if any, including the proper amount of statutory interest, if any, on any recovery of tax by plaintiffs, to be determined pursuant to Rule 47 (c) (2).

Conclusion of Law.

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes as a matter of law that plaintiffs are not entitled to recover, and, therefore, the petition is dismissed.

Judgment.

In the United States Court of Claims

No. 275-62.

John E. McCullough and Esther D. McCullough

v.

The United States.

Order.

This case comes before the court on plaintiffs' motion to correct opinion. Upon consideration thereof,

It Is Ordered that the Plaintiffs' motion be and the same is granted in that the decision of April 16, 1965, entered herein is amended as follows:

(a) that the word "action" in line 6 of page 12 of the slip opinion of April 16, 1965, be and the same is stricken and the words "position regarding this issue" are inserted in lieu thereof;

(b) that the words "that plaintiffs cannot recover" in lines 27 and 28 on page 13 of the said slip opinion be and the same are stricken and the words "the issue of

deficit carryover adversely to plaintiffs" be inserted in lieu thereof;

(c) that the words "Plaintiffs' petition is dismissed." appearing at line 7 of page 14 of the said slip opinion be and the same are stricken and the following inserted in lieu thereof: "However, under the stipulation of the parties (finding 22 (ii), *infra*) this determination means that plaintiffs incurred a long-term capital loss in 1957, as a result of the sale of their Frisco stock. The amount of recovery to which plaintiffs are entitled on account of this loss is to be determined pursuant to Rule 47 (c) (2).";

(d) that the words "are not entitled to recover, and, therefore, the petition is dismissed." appearing in lines 3 and 4 of the conclusion of law at page 33 of the said slip opinion be and the same are stricken and the following inserted in lieu thereof: "are entitled to recover in accordance with finding 22 (ii), *supra*, with the amount of recovery to be determined pursuant to Rule 47 (c) (2)."

By the Court,

Wilson Cowen,
Chief Judge.

Apr. 26, 1965.

In the

United States Court of Claims.

No. 275-62.

John E. McCullough and Esther D. McCullough

v.

The United States

Order.

On April 16, 1965, the court rendered an opinion together with findings of fact, amended by order of April 26, 1965, holding that the plaintiffs were entitled to re-

cover and entering judgment to that effect. The determination of the amount of recovery was reserved pending further proceedings pursuant to Rule 47 (c).

On June 16, 1965, the commissioner of this court filed a memorandum report recommending that, in accordance with the opinion of the court, as amended, judgment be entered for plaintiffs in the sum of $276.79, plus interest thereon from April 15, 1959, as provided by law, which recommendation is adopted by the court.

Now, Therefore, It Is Ordered that judgment be and the same is entered for plaintiffs in the sum of two hundred seventy-six dollars and seventy-nine cents ($276.79), plus interest thereon from April 15, 1959, as provided by law.

Jun 18, 1965

By the Court
Wilson Cowen
Chief Judge

APPENDIX B.

Statutes Involved.

Internal Revenue Code of 1954

Section 301 (c)

(c) Amount Taxable—In the case of a distribution to which subsection (a) applied—

(1) Amount Constituting Dividend—That portion of the distribution which is a dividend (as defined in Section 316) shall be included in gross income.

(2) Amount Applied Against Basis—That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) Amount in Excess of Basis—

(A) In General—Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) Distributions Out of Increase in Value Approved Before March 1, 1913—That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

Internal Revenue Code of 1954

Section 316 (a)

(a) General Rule—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

Internal Revenue Code of 1954

Section 381 (c) (2)

(2) Earnings and Profits—In the case of a distribution or transfer described in subsection (a)—

(A) the earnings and profits or deficit in earnings and profits, as the case may be, of the distributor or transferor corporation shall, subject to subparagraph (B), be deemed to have been received or incurred by the acquiring corporation as of the close of the date of the distribution or transfer; and

(B) a deficit in earnings and profits of the distributor, transferor, or acquiring corporation shall be used only to offset earnings and profits accumulated after the date of transfer. For this purpose, the earnings and profits for the taxable year of the acquiring corporation in which the distribution or transfer occurs shall be deemed to have been accumulated after such

distribution or transfer in an amount which bears the same ratio to the undistributed earnings and profits of the acquiring corporation for such taxable year (computed without regard to any earnings and profits received from the distributor or transferor corporation, as described in subparagraph (A) of this paragraph) as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.

In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 372

JOHN E. AND ESTHER D. McCULLOUGH, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioners, shareholders of the St. Louis-San Francisco Railway Company (hereafter referred to as Frisco), claim that a portion of the cash distributions they received in 1957 and 1958 exceeded Frisco's current earnings and profits and to that extent the distributions constituted a return of capital rather than a taxable dividend (Pet. 11–12). Resolution of this question depends on whether Frisco, which was reorganized in a section 77 [1] bankruptcy proceeding on January 1, 1947 (Pet. 13), is permitted to carry over a pre-reorganization deficit to offset post-reorganiza-

[1] Bankruptcy Act, c. 541, 30 Stat. 544, as amended, Sec. 77 (11 U.S.C. 205).

790-740—65

tion earnings and profits. All parties agree that if the pre-reorganization deficit does not carry over, Frisco had sufficient accumulated earnings to make the full 1957–1958 distributions taxable as dividends (Pet. 4, 42).

During the 1947 bankruptcy reorganization all of Frisco's outstanding stock was eliminated and cancelled as worthless. The secured creditors received all of the new stock (Pet. 14). Every court which has considered the effect of a bankruptcy reorganization on the earnings and profits account (including the Court of Claims in the instant case) has concluded that a pre-reorganization deficit does not survive a reorganization in which the shareholders' interests are extinguished, and that such a deficit may not be used to offset post-reorganization accumulated earnings and profits. The decision below is correct and there is no conflict of decisions or other occasion for review by this Court.

1. Any distribution made by a corporation to its shareholders out of either current earnings and profits or earnings and profits accumulated since 1913 constitutes a dividend. Int. Rev. Code of 1954, § 316. Distributions in excess of earnings and profits constitute a return of capital. 1954 Code § 301(c). Congress selected accumulated earnings to serve as the yardstick in order to distinguish distributions that represent a return *of* original invested capital from those corporate distributions that represent a return *on* original invested capital (*i.e.*, a dividend).*

* See 1954 Code §§ 312, 316; Treas. Regs. §§ 1.312, 1.316.

Thus, the existence of an earnings deficit indicates that operating losses have impaired the original contributed capital and any distributions to stockholders would constitute a further impairment, *i.e.*, a return of capital.

When, as in this case, it is determined in a bankruptcy proceeding that operating losses (which are reflected in the deficit) plus declines in the market value of the assets (which are not taken into account in computing earnings and profits) have completely extinguished the stockholders' investment, elimination of the stockholders from participation in the reorganized company should also eliminate the deficit. The stockholders then recognize their losses (through worthless stock deductions—see 1954 Code § 165(g)) and their interest in the bankrupt company is closed out. Since the losses which created the deficit and eliminated the stockholders' equity interest have been recognized by the stockholders, the deficit should also be closed out.

After a new group of stockholders replaces the eliminated stockholders, it makes no sense to carry over the old stockholders' deficit. The amount of the deficit bears no relation to the new stockholders' investment in the corporation or their gain or loss. For example, assume that the original stockholders invested $1,000,000 and the bondholders loaned the corporation $200,000, that the corporation lost $1,000,000 and then went through a bankruptcy reorganization with the bondholders getting all the stock. The deficit of $1,000,000 would have no rela-

tionship to the capital invested by the new stockholders ($200,000), or to their unrecognized gain or loss on the exchange of their bonds for stock. If the deficit were carried over, the corporation could earn $1,000,000 and in a later year distribute that amount to the new stockholders without any dividend tax.

Thus, the court below correctly held (Pet. 24) that the bankruptcy reorganization "eliminated the deficit", that there was no deficit to carry forward, and that any other conclusion would have resulted in an unjustified tax benefit akin to a double deduction (once to the old stockholders as a worthless stock deduction and once to the corporation in computing dividends paid to the new stockholders).[3]

2. Every court that has considered the effect of a bankruptcy reorganization in which the stockholders are eliminated has concluded that a pre-bankruptcy deficit may not be carried forward to offset post-bankruptcy accumulated earnings. *United States* v. *Kavanagh*, 308 F. 2d 824 (C.A. 8); *Banister* v. *United States*, 236 F. Supp. 972 (E.D. Mo.), appeal to C.A. 8 dismissed; *Dunning* v. *United States*, 232 F. Supp. 915 W.D. Mo.), on appeal to C.A. 8; *Caspers* v. *Commissioner*, 44 T.C. 411. Indeed, where the stockholders have been eliminated, even a surplus in earnings is not carried forward. *Humpage* v. *Commis-*

[3] This result is also in accord with standard accounting practice. See, *e.g.*, Paton and Dixon, *Essentials of Accounting* (1958 ed.), pp. 645–649. Accordingly, no entry was made on the books of the reorganized company to reflect the claimed deficit. (Pet. 39.)

sioner, 17 T.C. 1625, acquiescence, 1962-2 Cum. Bull. 4.

Petitioners do not allege that there is a conflict in decisions among the courts of appeals but suggest that there is a "conflict in principle" (Pet. 5) between the instant decision, on the one hand, and *United States* v. *Snider*, 224 F. 2d 165 (C.A. 1) and *United States* v. *El Pomar Investment Co.*, 330 F. 2d 872 (C.A. 10), on the other. No such conflict exists. *Snider* involved a Massachusetts real estate trust (taxable as a corporation) operating two unsuccessful hotels which was reorganized into a parent and subsidiary corporation. No bankruptcy proceeding was involved and there was no material change in shareholders, assets, liabilities or business operations. Accordingly, the court held that the deficit of the trust carried over to the parent corporation.

El Pomar involved a bondholder's purchase of the assets of an unsuccessful corporation at a foreclosure sale in 1920. The assets were transferred to a new corporation in which the bondholders received new bonds and common stock. In 1929, a second foreclosure sale occurred and the assets were transferred to a third corporation. All shareholders of the second corporation continued as shareholders of the third corporation. On these facts, the court held that the deficit of the second corporation was available to offset the earnings of the third corporation. The court specifically stated that it was not holding that a deficit carried over through the first foreclosure sale (330 F. 2d at 885), and it distinguished *United States*

v. *Kavanagh, supra*, from the case before it on the ground that in *Kavanagh* the equity of the old stockholders was entirely wiped out while in the second *El Pomar* reorganization "all of the stockholders of the predecessor corporation became stockholders of the successor corporation, resulting in a continuity of stock ownership" (330 F. 2d at 884).[*] Accordingly, neither decision is in conflict with the decison below.

3. Prior to the Internal Revenue Code of 1954 (the transaction here in question took place in 1947) there was no statutory provision relating to the carryover of earnings and profits under any circumstances; judicial decisions had required corporations to carry over accumulated earnings in certain tax-free non-bankruptcy reorganizations in order to prevent tax avoidance. Since these decisions are not in any way inconsistent with the court's decision in the instant case, petitioners try to create the impression that the lower court decisions are "inconsistent and confusing" (Pet. 6), by referring to the varying views of the lower courts with regard to non-bankruptcy reorganizations which were finally resolved by this Court in *Commissioner* v. *Munter*, 331 U.S. 210, and *Commissioner* v. *Phipps*, 336 U.S. 410.

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[*] We do not suggest that *El Pomar* was correctly decided. As the court below noted (Pet. 20, fn. 16) the stockholders of the second corporation became stockholders of the third corporation only because the same individuals were also bondholders. However, the failure of the court of appeals in *El Pomar* to disregard the continuity of stock ownership on these facts and make the tax result turn on the substance of the transaction can hardly be regarded as even a "conflict in principle".

4. Indeed, this Court's decision in *Phipps* not only highlights the invalidity of petitioner's claim here but also presents an alternative basis of affirmance. That case held that the deficits of several subsidiary corporations could not be used to offset the earnings of the parent corporation after a tax-free liquidation of the subsidiaries. This Court explained that allowance of a deficit carryover would permit the premature recognition of losses the tax effects of which Congress intended to defer when it made the liquidation of a subsidiary into a parent nontaxable. 336 U.S. at 421. Since the reorganization here was nontaxable with respect to both the corporation and the bondholders who became shareholders, permitting a deficit carryover would result in exactly the same premature recognition of deferred tax effects that was condemned in *Phipps*.

5. In Section 381(c)(2) of the Internal Revenue Code of 1954, Congress for the first time created specific statutory rules governing the carryover of earnings and profits in certain tax free reorganizations. Although taxpayers admit that this provision is not applicable to the reorganization involved here, they seem to imply that if the 1954 Code were applicable they would be entitled to the claimed carryover (Pet. 8). However, by failing to include Section 381(a) in their statutory appendix, taxpayers have simply glossed over the fact that Section 381 does not apply to insolvency reorganizations at all.

6. The decision below is entitled to affirmance on a separate and alternative ground that the Court of

Claims had no occasion to reach. Frisco's entire deficit was attributable to the accrual of interest on its defaulted bonds, which interest was discharged by the reorganization. Frisco's pre-1947 deficit was approximately $51,000,000; at least $101,000,000 of accrued interest was discharged in 1947 as a part of the bankruptcy reorganization. (Pet. 13-14, 37, 41.) Accordingly, the amounts deducted from earnings and profits when the interest accrued must be restored to earnings and profits when liability for the accrued interest was discharged. Therefore, no pre-organization deficit exists. See, *e.g.*, Rev. Rul. 58-546, 1958-2 Cum. Bull. 143; 1 Mertens, *Law of Federal Income Taxation* (Rev. 1962) § 9.32.

For these reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

THURGOOD MARSHALL,
Solicitor General.
RICHARD M. ROBERTS,
Acting Assistant Attorney General.
PHILIP R. MILLER,
FRED R. BECKER,
Attorneys.

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